Supreme Court, U.S.
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No. 94-1497

In the Supreme Court of the United States

OCTOBER TERM, 1994

MICHAEL J. O'MALLEY, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF ILLINOIS

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION IN OPPOSITION

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QUESTION PRESENTED

Whether, in an action by the Federal Deposit Insurance Corporation to recover on a facially unqualified loan guarantee executed in favor of a failed bank, 12 U.S.C. 1823(e) bars the guarantor from asserting as a defense a purported release or side agreement that was neither approved by the board of directors or loan committee of the failed bank nor reflected in the bank's books and records.

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OPINIONS BELOW

The opinion of the Supreme Court of Illinois (Pet. App. 1-29) is reported at 643 N.E.2d 825. The opinion of the Appellate Court of Illinois for the First District (Pet. App. 31-69) is reported at 618 N.E.2d 818. The opinion of the Circuit Court of Cook County, Illinois (Pet. App. 71-75) is unreported.

JURISDICTION

The judgment of the Supreme Court of Illinois was entered on October 27, 1994. A petition for rehearing was denied on December 5, 1994. Pet. App. 30. The petition for a writ of certiorari was filed on

March 6, 1995. The jurisdiction of this Court is invoked under 28 U.S.C. 1257(a).

STATEMENT

1. In 1975, when petitioner and Wayne J. Bekta were directors and shareholders of the First National Bank of Oak Lawn (the Bank), they approached Dennis Dine, an experienced real estate developer and customer of the Bank, with a proposal to participate in the purchase of property for development. Dine agreed to apply for an acquisition loan from the Bank, using the property as collateral, and to share with petitioner and Bekta any profit from the development or sale of the property. Pet. App. 1-2.

In connection with Dine's loan application, petitioner and Bekta both executed personal guarantees, unconditionally guaranteeing all of Dine's obligations to the Bank, whether then existing or created in the future, up to and including $225,000, plus interest on such amount. Pet. App. 32. Petitioner asserts that those guarantees were to be used, if needed, as additional security for the acquisition loan. Petitioner was aware when he executed his guaranty of its legal effect, and he delivered the executed guarantee to Bekta without waiting to determine whether the Bank would approve the loan with only the property as collateral. *Id.* at 2.

John Geary, the president of the Bank, ultimately approved the loan to Dine. At trial, Geary testified that, based on the Bank's appraisal, the property was sufficiently valuable to serve as full security for the loan. Geary further testified that he saw petitioner's guarantee for the first time at a pre-trial deposition. The Bank records relating to the Dine loan that were

offered into evidence at trial contained no reference to the guarantee. Pet. App. 2-3.

In 1979, petitioner sold his stock and resigned as a director, ending his relationship with the Bank. Petitioner testified at trial that, at the time of his departure, he exchanged mutual releases with the Bank. Petitioner introduced a letter, dated October 1, 1979, executed by Bank president Geary and witnessed by the Bank's vice-president, that purported to release petitioner generally from any obligations to the Bank, as well as a letter that petitioner had written to the Bank, releasing the Bank from any obligations that it owed to him. No evidence of those mutual releases was found in the Bank's records, nor were they reflected in any board of directors or loan committee minutes. Pet. App. 3-5.

2. On April 29, 1983, the Bank was declared insolvent, and the Federal Deposit Insurance Corporation, in its corporate capacity (FDIC), acquired the Bank's assets. Those assets included two outstanding and unpaid notes that had been executed by Dine, and petitioner's unconditional guarantee, which was found in the Bank's loan collateral file. The FDIC sought repayment from Dine, but Dine filed a petition for bankruptcy. The FDIC then demanded payment from petitioner pursuant to the guarantee. When petitioner refused payment, the FDIC filed this action in Illinois state court, seeking to enforce petitioner's obligations under the guarantee. Pet. App. 4-5.

3. In the course of a bench trial, petitioner claimed that the guarantee was intended to be used only if necessary for Dine to obtain approval for the acquisition loan, and he asserted further that any guarantee obligations that he may have assumed were

released by the Bank in 1979. Pet. App. 33. At the trial's conclusion, the court found that petitioner had executed an unqualified guarantee of Dine's existing and future loans, capped at $225,000 (plus interest and expenses); that the guarantee was in the collateral files of the Bank at the time the FDIC became receiver; and that Dine was indebted to the Bank for an amount greater than $225,000. Absent a valid defense, petitioner would therefore be indebted to the FDIC for $225,000, plus interest and expenses. The court held further that 12 U.S.C. 1823(e) precluded petitioner from asserting as a defense to the FDIC's enforcement of the guarantee the existence of any unrecorded agreement or understanding that the guarantee was to be used only if necessary for Dine to obtain the acquisition loan.[1] Pet. App. 37-39. And,

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[1] Section 1823(e) provides:

> No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement—
>
> (1) is in writing,
>
> (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,
>
> (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and
>
> (4) has been, continuously, from time of its execution, an official record of the depository institution.

12 U.S.C. 1823(e) (Supp. V 1993)

in the absence of any evidence of an accord and satisfaction or full payment, the court rejected petitioner's contention that the guarantee had been extinguished prior to the Bank's failure. *Id.* at 45.

4. The court of appeals affirmed. Pet. App. 31-69. The court rejected petitioner's argument that he had been released from the guarantee obligation in 1979, holding that the purported release could not be asserted against the FDIC because it had not been approved by the Bank's board of directors or loan committee, and was not reflected in the Bank's records, as required by 12 U.S.C. 1823(e)(3) and (4). Pet. App. 42-45. The court also rejected petitioner's claim that the guarantee was not binding because he had intended that it be used only if needed for Dine to obtain the loan. In the court's view, having signed the facially unqualified guarantee, petitioner was barred by Section 1823(e) from relying on any unrecorded understanding that the guarantee would be used only under certain circumstances. Pet. App. 41-42. Finally, the court rejected petitioner's argument that, because the guarantee authorized release of the guarantor, his alleged release in 1979 arose, not out of a collateral agreement, but from the express terms of the guarantee itself. The court acknowledged that Section 1823(e) permits assertion against the FDIC of defenses that arise from the failure of the bank to perform its contractual obligations, but it found that principle inapposite here, because the guarantee permitted the Bank to release petitioner, but did not obligate the Bank to do so. Pet. App. 46-48.

5. The Illinois Supreme Court affirmed. Pet. App. 1-29. The court rejected petitioner's argument that, as a result of the purported release, the guarantee

was not an "asset" of the Bank that could have been acquired by the FDIC. Joining numerous federal courts that have rejected similar arguments, the court held that to permit petitioner to avoid his facially unqualified obligation on the strength of a nonconforming release agreement would "render the protection of [Section 1823(e)] meaningless." Pet. App. 17-18.

The court also rejected petitioner's argument that the guarantee was "no asset" because petitioner had not intended it to be enforceable unless Dine could not otherwise obtain the acquisition loan. Pet. App. 15-17. The court concluded that Section 1823(e) does not permit the assertion of an unwritten understanding to render unenforceable a facially unqualified guarantee. It found unimpressive petitioner's emphasis on the absence of parol evidence that the guarantee was intended to serve as collateral for the loan. In the court's view, the unqualified guarantee itself conclusively demonstrated petitioner's obligation. Pet. App. 16.

The court found equally unavailing petitioner's argument that his release arose directly out of the guarantee. The guarantee contained no manifest obligation on the Bank to release petitioner, and bank examiners would therefore not know from a review of the guarantee whether any release had been issued. Pet. App. 16.

ARGUMENT

Section 1823(e) establishes requirements with which an agreement must comply for that agreement to form the basis for a defense against the FDIC's suit to enforce obligations adhering in an acquired asset. Since this Court's decision in *Langley* v. *FDIC*,

484 U.S. 86 (1987), courts applying Section 1823(e) have consistently rejected the assertion of releases, side agreements, or conditions that fail to satisfy the statute's requirements. In this case, it is undisputed that neither petitioner's purported understanding regarding limitations on the effectiveness of his guarantee, nor petitioner's alleged release from the guarantee, were approved by the Bank's board of directors or loan committee or reflected in the Bank's records, as required by Section 1823(e)(3) and (4). The Illinois Supreme Court therefore applied settled law when it barred petitioner from asserting those defenses to his facially unqualified guarantee.

1. Petitioner argues (Pet. 11-23) that because his alleged release was executed before the Bank failed, the guarantee was no longer an "asset" when the FDIC acquired the Bank. And if the guarantee was not an asset, he contends, Section 1823(e) is not implicated and the release is not subject to the statute's exacting requirements.

In *Langley*, this Court held that Section 1823(e) precluded the obligors' assertion against the FDIC of a defense based on the failed bank's alleged misrepresentation of facts material to an acquisition loan, under circumstances in which no reference to the alleged misrepresentations appeared in the loan documents, bank records, or in any minutes of the bank's board of directors or loan committee. The Court recognized that "the essence of [the borrower's] defense * * * [was] that the bank made certain warranties regarding the land, the truthfulness of which was a condition to performance of their obligation to repay the loan." 484 U.S. at 90-91. Finding the term "agreement" in Section 1823(e) broad

enough to include a condition of performance, 484 U.S. at 91, the Court held that the statute precluded the obligors from asserting as a defense any alleged misrepresentation that failed to meet the statute's requirements. *Id.* at 96.

There is no relevant conceptual distinction between *Langley* and this case. Just as the unrecorded misrepresentation alleged in *Langley* was ineffective as a defense to the obligor's otherwise valid loan agreement, petitioner's unrecorded release is ineffective to extinguish petitioner's otherwise unqualified guarantee.

The Illinois Supreme Court's decision is fully in line with the views of the federal courts, which have consistently rejected the "no asset" defense to an obligation when a purported release (or other agreement asserted as evidence that the FDIC did not acquire an "asset") does not itself satisfy the requirements of Section 1823(e). See, *e.g.*, *FDIC* v. *P.L.M. International, Inc.*, 834 F.2d 248, 253 (1st Cir. 1987); *FDIC* v. *Merchants' National Bank*, 725 F.2d 634, 639 (11th Cir.), cert. denied, 469 U.S. 829 (1984); *FDIC* v. *Manatt*, 922 F.2d 486, 488-489 (8th Cir.), cert. denied, 501 U.S. 1250 (1991); *FDIC* v. *Krause*, 904 F.2d 463, 466 (8th Cir. 1990) ("settlement agreement" with the bank president barred where the notes remained in the active file, were not stamped "paid," and the bank's minutes did not reflect approval of the settlement).[2]

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[2] Petitioner's reliance (Pet. 12-13) on *FDIC* v. *Nemecek*, 641 F. Supp. 740 (D. Kan. 1986), *Commerce Fed. Sav. Bank* v. *FDIC*, 872 F.2d 1240 (6th Cir. 1989), and *FDIC* v. *Prann*, 694 F. Supp. 1027 (D.P.R.), aff'd *sub nom. FDIC* v. *Bracero & Rivera*, 895 F.2d 824 (1st Cir. 1988), is misplaced. *Nemecek* was decided before this Court's decision in *Langley*. In *Commerce* and *Prann*, the courts concluded that the FDIC had

2. Petitioner contends (Pet. 13) that even though his purported release was not approved by the Bank's board of directors or loan committee (as required by 12 U.S.C. 1823(e)(3)), and was not found among the Bank's records (as required by 12 U.S.C. 1823 (e)(4)), it was not a "hidden side agreement" because it was in writing and was executed by the Bank's president. In petitioner's view, because the release was not a "hidden side agreement," it is enforceable. *Ibid.* That argument ignores the nature of the rule enacted in Section 1823(e). As this Court recognized in *Langley*, "Congress opted for the certainty of the requirements set forth in Section 1823(e). An agreement that meets them prevails even if the FDIC did not know of it; and an agreement that does not meet them fails even if the FDIC knew." 484 U.S. at 95. Because petitioner's purported release does not comply with the statute's requirements, the courts below correctly held that it may not be asserted to defeat the FDIC's interest in the guarantee.[3]

3. Petitioner argues (Pet. 3-4, 13-16) that because he did not intend his guarantee to be used

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acquired "no asset" because the underlying debts had been paid in full prior to the failure of the banks. See *Commerce Fed.*, 872 F.2d at 1246; *Bracero & Rivera*, 895 F.2d at 830. In this case, petitioner does not assert that the Dine debt has been paid.

[3] Among other things, Section 1823(e) protects the FDIC from the potential collusive restructuring of agreements—including restructuring that might be effected through execution of an unrecorded release that diminishes the interest of the Bank, and ultimately the FDIC, in a facially unqualified guarantee. Cf. *Langley*, 484 U.S. at 92-93 (interpreting Section 1823(e) to protect against schemes whereby the banking authorities may be misled).

unless Dine could not otherwise obtain the acquisition loan, the guarantee lacked the mutual intent and consideration necessary to create an enforceable obligation. That version of the "no asset" argument also runs afoul of Section 1823(e), because the argument relies ultimately on an alleged unwritten understanding between petitioner and the Bank that petitioner's facially unqualified guarantee was subject to conditions. Pet. App. 16. As this Court stated in *Langley*, "one who signs a facially unqualified note subject to an unwritten and unrecorded condition upon its repayment has lent himself to a scheme or arrangement that is likely to mislead the banking authorities." 484 U.S. at 93.

As the Illinois Supreme Court observed (Pet. App. 15-16), the federal courts have consistently barred obligors from asserting unrecorded conditions to repayment of their obligations. See, *e.g.*, *FDIC* v. *McClanahan*, 795 F.2d 512 (5th Cir. 1986) (defendant who signed a document in blank lent himself to a scheme that would mislead bank examiners); *Adams* v. *Madison Realty & Development, Inc.*, 937 F.2d 845 (3d Cir. 1991); *FDIC* v. *Powers*, 576 F. Supp. 1167, 1171 (N.D. Ill. 1983), aff'd, 753 F.2d 1076 (7th Cir. 1984) (party who signed guarantee barred from asserting that guarantee was not executed in connection with loan).[4]

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[4] *Commerce Fed. Sav. Bank* v. *FDIC, supra,* does not support petitioner's position. The court in *Commerce* held that legal invalidity may be asserted when the asserted invalidity is "independent of any understanding or side agreement." 872 F.2d at 1245. In this case, petitioner's argument rests on an unrecorded side agreement that allegedly imposed a condition precedent on his facially unqualified guarantee.

4. Petitioner claims (Pet. 16-19) that the possibility that he might be released from his guarantee was reflected in the text of the guarantee, and that his defense based on his alleged release is therefore not barred by Section 1823(e). Several cases have held that an obligor may assert against the FDIC a defense based on a bank's failure to perform its own obligations under the instrument that the FDIC seeks to enforce. Those cases, however, have required that the bank's obligations be manifest and explicit on the face of the instrument. See, *e.g.*, *Howell* v. *Continental Credit Corp.*, 655 F.2d 743, 746-747 (7th Cir. 1981); *FDIC* v. *Venture Contractors, Inc.*, 825 F.2d 143, 149-150 (7th Cir. 1987); *FDIC* v. *O'Neil*, 809 F.2d 350, 353-354 (7th Cir. 1987); *FDIC* v. *Virginia Crossings Partnership*, 909 F.2d 306, 312-313 (8th Cir. 1990). In this case, petitioner's guarantee "did not contain terms that imposed responsibilities on the Bank. The guarantee provided only for the bare possibility that the Bank might issue a release at some point in the future." Pet. App. 21. The FDIC thus does not seek here selectively to enforce certain terms of the guarantee while ignoring others.

Petitioner's reliance on *FDIC* v. *Panelfab Puerto Rico, Inc.*, 739 F.2d 26 (1st Cir. 1984), is unavailing. That case concerned the effectiveness of a letter sent by guarantors revoking and cancelling their guarantees. The guarantors had the express contractual right unilaterally to revoke their guarantees; their written notice of cancellation was timely received by the bank; and the notice was contained in the bank's records. The court of appeals held under those circumstances that the guarantors' cancellation was not itself an "agreement" subject to the

requirements of Section 1823(e). That holding provides no support for petitioner's argument that his mutual release with the Bank was not an "agreement" within the meaning of the statute. *Id.* at 30.[5]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[5] Petitioner also argues (Pet. 19-20) that, under a literal interpretation of the statute, all releases would be barred for failure to meet the requirements of Section 1823(e)(2), because no release is executed contemporaneously with the creation of the obligation and releases are frequently not executed by the party being released. Pet. 19-20. That concern is not implicated in this case. The Illinois Supreme Court did not rest its decision on the failure to satisfy the requirements of subsection (2), but held that petitioner's alleged release did not satisfy the requirements of Section 1823(e)(3) and (4), because the release was never approved by the Bank's board of directors or loan committee and was not contained in the Bank's records. Pet. App. 17.

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